

THE ASSOCIATION OF GLOBAL CUSTODIANS

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30 June 2010

By Electronic Delivery

Ric Wilding
Client Assets Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

RE: Consultation Paper – Enhancing the Client Assets Sourcebook

Dear Sir:

We write on behalf of the members of the Association of Global Custodians (the "Association") to convey members' views in response to the Financial Services Authority's ("FSA") consultation paper, dated March 2010, "Enhancing the Client Assets Sourcebook ('CASS')." ¹ The Association's comments below address, in particular, points made and questions raised in Part 3b) of the consultation paper, "Prohibiting the use of general liens in custodian agreements".

As a general matter, the Association appreciates the view expressed in the consultation paper that the CASS regime could be strengthened in the light of experience gained during the financial crisis. Members also recognize the value of public review of the rules and practices surrounding custody so as to promote greater client protection and market stability. However, members believe that the FSA's proposal to introduce a CASS rule that would prohibit the use of general liens over client assets held under custodian agreements "except when a firm ... or client does not pay custodian 'fees and charges' [to the custodian]", is overbroad and will not achieve those stated goals. The reasons for members' view are set out below in relation to Questions 13 – 15 of the consultation paper.

¹ Members of the Association are listed on the letterhead above. As you know, members act as custodians for cross-border institutional investors world wide, providing custody services and asset-servicing functions through a global network of agents and subcustodians. Members provide these services to institutional investors that make active and substantial investments in European securities markets.

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Question 13: Do you agree that we should introduce a rule prohibiting the use of general liens in custodian agreements and amending existing guidance to clarify our requirements?

Liens typical to custodians' agreements apply not merely to unpaid custody "fees and charges" but to cover a client's obligation to make payments that arise in the course of receiving custody services, including unpaid indemnities in the custodian's favor and unsatisfied settlement payment obligations.² Custodians take rights -- typically referred to in the industry as a "custodian's lien" or other form of security interest -- over client assets to protect the custodian against the financial exposures that accompany these unpaid liabilities. These credit exposures, which can be significant, arise as a matter of course in providing custody functions to facilitate efficient and timely settlement of client securities transactions and to fulfill foreign exchange transactions with or on behalf of clients.

With respect to settlement of client trades, for example, one primary custodian function is to advance funds to clients to facilitate *contractual settlements* or to make intraday payments. To protect itself against the credit exposure associated with such advances, the custodian, as a creditor, must take certain rights over the clients' assets. Similarly, a custodian typically takes rights over clients' assets for indebtedness of the client arising from a *forward foreign exchange transaction* that the client has instructed the custodian to settle.

As a related point, it is established practice in some local markets that liens arise in favor of central depositories in the course of settling securities trades for the accounts of depository participants. Liens may arise under depository rules or by operation of local law. Global custodians have no choice in the selection of any market-essential central depository, and either the global custodian (when it is a direct participant) or its participating sub-custodian(s) typically must agree to the non-negotiable terms of participation. These transitory liens thus arise in such jurisdictions and exist irrespective of particular language in a custodian's agreement with a client. If a client fails to meet a settlement obligation and the central depository demands payment from the custodian for purchased securities, the custodian must be able as a legal matter to sell those securities to cover the payment to the central depository. The exercise of a custodian's lien in such circumstances is fully consistent with market practice and statutory liens in favor of intermediaries in the trade process.

Question 14: Do you think that we should go further and prohibit all liens in custodian agreements?

For the reasons outlined above, we disagree with any proposal to prohibit all liens in custodian agreements.

² We understand that the phrase "custodian fees and charges" as used in the consultation proposal may well not encompass overdraft or foreign exchange extensions of credit. If this is incorrect and the proposal would encompass those exposures, this should be clarified.

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Question 15: Do you foresee any unintended consequences in implementing this proposal?

If a custodian were required to extend credit to its clients without standard recourse or protective arrangements, as the FSA's proposed rule seems to require, prudent custodians would likely cease to make these credit facilities available. Failed trades would increase, and custodians might cease to provide contractual settlement altogether or, instead, might require clients to pre-fund trading activity. Those effects would likely impair clients' cash flows, decreasing market liquidity and settlement predictability and potentially decreasing investment returns given the need to maintain higher cash balances. At a minimum, standard settlement flows would undergo significant change.

In addition, if a custodian decided to advance funds for its clients' benefit without credit protections and take the risk of unsecured credit exposure, the custodian would not only be potentially more vulnerable to systemic risk but would be required to make higher capital allocations against the risk. This would increase costs that would assuredly be passed on to investors. Further, the custodian would face direct exposure to the client with no means of secured recourse, which could impair the custodian's liquidity.

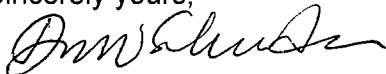
Those consequences provide examples of ways in which the rule proposal would not increase market stability or enhance appropriate investor protections.

As a general principle, if the FSA believes that some firms in the US have inappropriately allowed custodians to use "general liens", the FSA should evaluate the specific behaviors and review the variety of liens and creditors' rights in use in fact and consider appropriately-tailored rulemaking or legislation that would define the range and scope of statutory rights, including the efficacy of particular rights in insolvency contexts. Indeed, rather than prohibiting liens outright, we encourage the FSA to work toward promoting greater legal certainty in respect of the use of custodial security interests.

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The Association very much appreciates the opportunity to convey members' views on these topics. If you have questions or would like additional information, please contact Katherine Petcher, Esq. at katherine.petcher@rbcdexia.com or the undersigned at 1.312.861.2620 as an initial matter.

Sincerely yours,



Dan W. Schneider
Baker & McKenzie LLP
Counsel to the Association